SUPPLEMENTARY SUBMISSION TO THE PRODUCTIVITY COMMISSION

THE NATIONAL ACCESS REGIME

June 2001

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EXECUTIVE SUMMARY

ENERGEX Limited (ENERGEX) welcomes the Commission's Position Paper and appreciates the opportunity to make a supplementary submission. There is much in the Position Paper with which ENERGEX agrees.

The purpose of this supplementary submission is to seek to persuade the Commission to shift from its proposed approach further along the track towards what ENERGEX regards as light handed incentive regulation and to allow the free play of market forces and rivalry in regulatory design. The recommendations contained here should be read in conjunction with those previously made in ENERGEX's original submission to the inquiry (December 2000).

ENERGEX envisages regulatory regimes throughout Australia which enable evolving forms of regulation to flourish. This would include forms where the focus would be on satisfying the requirements of the customers of regulated companies, as expressed through independent and audited surveys. Regulators have intervened themselves between businesses and customers and there is a significant Principal-Agent problem. The role of Regulators should, in our view, be confined to ensuring that regulatory arrangements proposed by businesses and their customers lie within the boundaries of a clearly enunciated objects clause.

In its Position Paper, the Productivity Commission has made the leap from command and control forms of regulation as currently applied in Australia to 'true' incentive regulation. Incentive regulation, where prices are de-linked from costs of the individual firm is undergoing evolutionary change. ENERGEX is not persuaded that governments, regulators or the Commission should prefer any particular approach to incentive regulation. The choice, rather, should depend on the particular requirements of regulated companies and their customers.

For its part, ENERGEX supports the approach pioneered by United Energy Limited in Victoria of price-service offerings constructed in conjunction with customers. This partnership approach offers the prospect of a step-up in the quality of a range of services towards international best practice. It is win/win not win/lose. This approach may not be familiar to the Commission and this submission provides some detail.

The starting point of good regulation would be the construction of an objects clause that satisfies the original intentions of the Hilmer reforms and CoAG. Those intentions are to maximise social welfare by the promotion of economic efficiency, including through investment, innovation, productivity improvement, technical progress and diversity of choice. In ENERGEX's view, the proposed objects clause in the Position Paper does not sufficiently capture all those elements, particularly with respect to innovation, technical progress and choice. There is also the risk that regulators will continue to focus on allocative efficiency and the short-term removal of any 'rents' rather than productive and dynamic efficiencies, which are more important.

To precisely reflect principle and policy, ENERGEX suggests that the first part of the objects clause becomes:

To promote long term productive and dynamic efficiency, focussing on the desirability of fostering investment, innovation, productivity improvement, technical progress and diversity of choice, and taking precedence over allocative efficiency.

In ENERGEX's December 2000 submission, it was recommended that a clause be inserted on potential abuse of market power that reflected the approach taken by the Federal Court and the ACCC. That is,

- to prevent misuse of market power where this power means *'giving less and charging more'*.

It appears that this was not taken up by the Commission and, on reflection, ENERGEX *withdraws* this recommendation for inclusion in the objects clause as it adds a complication and the issue is, in any event, covered by the Trade Practices Act 1974 and formal monitoring under what appears to be the Commission's intended use of the Prices Surveillance Act 1983.

ENERGEX considers that the Position Paper does not sufficiently close off the high risk that command and control regulation will continue to be imposed by requiring only that regulators 'show good cause'. Fine words in the 'objectives' of certain jurisdictional regulatory frameworks have not stopped regulators imposing their own objectives. Instead, it is suggested that:

All forms of command and control regulation (cost of service/rate of return), including 'building blocks' and the use of CPI-X where X is a residual, are mandated for elimination as regulatory options unless the regulated companies and their customers prefer such regulation and they can show that their proposal will achieve the objects clause.

If such a preference is expressed, than a further matter should be added to the objects clause requiring regulators:

To facilitate entry into relevant markets by setting prices based on the efficient cost and risk structures applicable to new entrants.

The key view that ENERGEX wishes to put to the Commission is that there is obvious reason why governments or regulators should be imposing any particular form of regulation. The Commission has previously suggested that there should be interstate rivalry between jurisdictional regulators so that good regulation would eventually drive out the bad. ENERGEX's suggestion is similar:

Let any regulated business and its customers choose the form that best suits their purposes as long as the objects clause is satisfied.

In some industries, regulated firms and their customers may prefer to trade off price for minimal services. In other industries or areas, firms and customers may prefer world class quality and a range of choice of services. Over time, both firms and customers may observe what is happening elsewhere and change their preference at the next review. That is what emulating effective competition in real world markets requires and that is what would be delivered. The role of regulators would be considerably reduced to simply assessing proposals against the objects clause and verifying the independent customer surveys and audits.

ENERGEX's December 2000 submission concluded, for the energy sector at least:

The Prices Surveillance Act 1983 be retained as a regulatory option.

There is no significant reason why an access regime is necessary beyond reliance on S.46 of the Trade Practices Act 1974 where ring fencing applies.

It is understood that the Commission is considering adaptations to the PS Act as a surrogate for the current regime. In this respect, ENERGEX would like to point out that:

The tripartite arrangements for governance of the PS Act under the Prices Surveillance Authority are likely to be superior to those that exist for the ACCC.

ENERGEX's original submission provided considerable material on other aspects of governance arrangements and governance principles. These are not repeated here.

Further, ENERGEX suggests that, for formal monitoring:

The Productivity Commission should examine how the Prices Surveillance Act 1983 (the Act) contained in the Competition Policy Reform Act 1995 may be re-vamped to accommodate the specific requirements of the objects clause for regulated entities under formal monitoring, especially S.27A of the Act.

With respect to using surveillance where regulated infrastructure providers:

- develop a mode of behaviour for failing to achieve the requirements of formal monitoring, or where
- there is strong reason to believe that a firm will use its market power to inflate profits or skimp on quality.

ENERGEX suggests that:

Prices surveillance may have a role as a threat to companies which perform poorly under formal monitoring. If imposed, the Directions to apply should reflect the objects clause and the original intentions of the surveillance mechanism. In the latter case, this includes price restraint but not price or profit control, and ensuring sufficient profits for investment, innovation, efficiency and employment.

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1. INTRODUCTION

ENERGEX Limited (ENERGEX) welcomes the Commission's Position Paper and supports much of what is argued.

This supplementary submission is modest. It is not much more than an extension of ENERGEX's original submission to this inquiry (December 2000) and listed on the Commission's web site (No 14). The main difference is that, in light of the Position Paper, it seeks to persuade the Commission in its final report to shift all the way to light handed incentive regulation, more closely emulating what happens in the real world imperfectly competitive (Schumpeterian) markets. It focuses on the circumstances in which evolving regulatory forms may flourish, and provides some detail on so-called 'price-service packages', a new approach pioneered by United Energy Limited in Victoria. This form has been described by community interest groups as a decade ahead of the rest.

ENERGEX is also financially supporting submissions by several groups. This is not to say that ENERGEX necessarily endorses all that is argued in those independent submissions, but they add value to the debate. For the sake of brevity, these and ENERGEX's original submission are taken here as read. Similarly, we focus here on where ENERGEX disagrees with the Position Paper: there is much in the Paper with which we agree. Two points of clarification are also made.

The original submission provided a critique of Australia's current regulatory arrangements; the access/price reviews which have taken place; and the determinations made by regulatory authorities. Two particular deficiencies previously identified which are relevant for this submission are:

- the access/price regimes are inappropriate and will result in low investment and productivity growth, lack of innovation and dynamic efficiency, and higher prices over time than otherwise,
  - reducing the competitiveness of user industries in tradeable markets, and
  - raising the prospect of severe supply disruptions (the original comments about California can now be seen as prescient);
- the regimes are not serving the long-term interests of consumers, including an inflexibility to evolving customer needs and ignoring the stated preferences of community and consumer groups;

The main problems ENERGEX has with the Position Paper are:

- objects clause:
  - while the need for investment is recognised, there is no similar acknowledgment for its twin – innovation – a core element of dynamic efficiency
- pricing principles/arrangements:
  - while cost of service/rate of regulation such as building blocks is not supported, it is still provided for by the Commission, subject only to a 'show good cause' provision;
  - while the Position Paper moves away from the dictum that prices must match or track costs, it still requires periodic cost-based resets. This is not necessary under a number for forms of "true" incentive regulation where the reference point is industry or international benchmarks;

- there is no recognition apparent about the desirability of infrastructure providers matching the services that their customers actually want;

- there is insufficient flexibility in the proposed arrangements for stakeholders to choose between regulatory forms, including price/quality trade-offs, or for new forms to be developed.

2. APPROPRIATE OBJECTS CLAUSE

2.1 Investment

Most stakeholders would agree that the purpose of regulatory policy should be to maximise social welfare or, as policy makers put it, to maximise the long-term interests of consumers. Those long-term interests require the encouragement of growth, innovation, technical progress and diversity of choice.

Several parties to this inquiry or to price reviews would not agree. They have been influential in recent price reviews where they have aimed to achieve low returns to be earned by infrastructure providers and short term price cuts. The long-term adverse consequences of command and control regulation and a focus on the short term were highlighted in ENERGEX's December 2000 submission where reference was made to the views of the eminent economists both here and overseas commenting on Australia, and other commentators such as financial houses and regulatory advisers.

Free riding on the future is a short-lived strategy. The analogy applied to monetary policy of a brick tied to a length of elastic is apt. One may pull on the elastic for a long while with no effect until, suddenly, the brick hits one in the face. No where is there a better example than in California. As assessed by the California Audit Office and Dr Larry Kaufmann in 'Energy *Regulation and the Role of Regulators'* (May, 2001) much of the blame for the rolling blackouts, high prices, insolvency of suppliers and industrial chaos lies with regulation. Alan Greenspan has warned that the situation is sufficient to destabilise the national economy.

The inappropriate regulation in energy wholesale, distribution and retail in California took a period of years to develop adverse effects. Dr Dan Fessler, the former President of the California Public Utilities Commission (CPUC) urged Australian regulators, most notably the Victorian Office of the Regulator-General, several years ago not to adopt the 'building block' model which was seen as analogous to the command and control regulation he was obliged to administer. At that time he warned that such regulation had performed poorly and was not in the long term interests of consumers, including rising costs, unpredictability and systemic failure. Dr Fessler's warning has had no effect here. As reported in ENERGEX's original submission, the CPUC has since eliminated command and control and switched to a form of 'true' incentive regulation in distribution. However, as Dr Kaufmann has said, any beneficial effects from this late switching in distribution regulation was swamped by the legacy of poor regulation across supply.

The Position Paper has recognised the danger to investment and growth of regulatory authorities undershooting in price setting but has not taken up the risks of micro-management by regulators in investment argued in ENERGEX's December submission. This is somewhat surprising as the Productivity Commission itself has earlier raised the point (Banks, 1999).

2.2 Dynamism

What also appears to be missing in the Position Paper – a vital matter in ENERGEX's view – is recognition of the need for dynamism: innovation, technical progress and diversity of choice. We do not repeat all the arguments in the original submission here except to say that dynamism is also central to the Hilmer reforms. As KPMG acknowledge:

> *"…We have National Competition Policy specifically because our utilities have failed to innovate and become more productive. They have been stuck on one S curve without the need or motivation to move. It is competition that normally drives the transition from one S curve to another. With a natural monopoly different mechanisms must be used and one of the most important of these mechanisms is the form of regulation applied".* [2000, p9]

ENERGEX is concerned that regulation will hinder rather than promote dynamism, with adverse long-term effects on consumers and user industries. What needs to be recognised is that the demand for the services of infrastructure industries is rapidly changing as a result of new technologies.

Of course, arguments about technological change as a sort of Promethean force deserve some scepticism, as witness the ultimate failures of the 'technology fixes' referred to by President Truman in 1949 and Prime Minister Harold Wilson in 1960. Nonetheless, evidence of a fundamental shift today is strong.

To take electricity as an example. First, there appears to be a bias in the nature of new capital investment and demand more generally towards electricity. For instance:

- *"… 60% of US capital investment now relates to things that are plugged into the wall."* [Mill–McCarthy, 1999]
- *"Electricity has increased its share of energy use from 25% to 40% over the past thirty years."* [Electricity Technology Roadmap, EPRI, 1999]

Secondly, electricity is the fuel for the evolving Information Age. Digital technologies that will be used in industries, businesses and the home need reliable power supply to function efficiently. Existing power grids can deliver "three nines" (99.9%) of quality but new technologies require "six nines" or more to function economically. Fortunately, there is the possibility of a positive feedback effect as digital controls and conditioning devices can be developed and applied to networks to improve reliability if the incentives are there.

Thirdly, the Internet and E-commerce will expand. Already 8% of the grid in the US is tied up in the Internet. The establishment of so-called server farms or Internet Data Centres can dramatically increase demand for the quantity and quality of supply. About the largest reported so far in Australia requires 40 MW of power but some in the US require 100 MW.

Another potential shift in demand could be through the convergence of technologies. One example here is the potential use of electric power for transportation but there are many others in major industries. Another force for change will be greater market contestability. This is likely to induce a convergence of electricity, gas, water, telecommunications and other services as companies seek economies of scale and of scope.

It was Joseph Schumpeter, writing between the wars, who showed that the forces shaping technological change are economic rather than scientific. Schumpeter's ideas have been extensively tested around the world and form the principles that prevail today.

As reported in ENERGEX's December 2000 submission, eminent economists and regulators such as Professors Michael Beesley, Fred Hilmer, Brian Johns and Steven Littlechild consider that regulators should be attempting to emulate effective competition in imperfect (Schumpeterian) markets if there is to be dynamism. As Beesley notes:

> *" The competition which is being 'mimicked' is not neo-classical competition but Schumpeterian. The Regulator is playing both the role of creating the possibility of earning innovatory gains and that of the 'perennial gale' of competition which tends to blow them away over time".* [Beesley, 1996, p213]

What these experts are saying is that there will be no dynamic efficiency or technical progress in the sorts of models currently employed in Australia. The Schumpeterian argument is that it is only the opportunity of higher returns than the perfectly competitive rate which will induce firms to undertake risky and uncertain investment and innovational activities that offer the prospects of enhanced services to customers at lower prices than otherwise. And it is the surplus from past earnings above the perfectly competitive rate that are a necessary pre-condition for firms to react to this incentive.

This raises the first point of clarification. A 'late' submission to this inquiry by Dwyer and Lim appears to interpret the above argument as having the purpose of showing that utilities are not monopolies. It is nothing of the sort. Whether or not utilities are monopolies is irrelevant here. The argument is simply about the need for 'headroom' on prices in an ex ante sense as a pre-condition for firms to innovate, as occurs in any real world unregulated imperfect market or under the patent system. They may or may not succeed in their innovation, and should reap the rewards of success or suffer the consequences of failure. This opportunity does not exist in the simple neo-classical perfectly competitive model applied by Australian regulators where ex post rates of return are imposed ex ante.

It is worth repeating the comments of Professor Jerry Houseman (MIT) on Australian regulation [ACCC, 15 July 1997].

> *" A cost based access fee would discourage dynamic efficiency for two reasons. First, a new entrant would not invest at efficient levels because cost based regulation does not reward risk taking for new services. Services which do not succeed never earn back their investment. However, services which do succeed only earn back their costs.*
>
> *The second reason why cost based regulation decreases dynamic efficiency is that firms do not have the economic incentive to increase productivity and lower costs through time. If firms lower their costs it leads to a reduction in their permitted access charges. To the extent that the regulator does its job correctly it will remove all incentive for productivity gain".*

The heads of regulatory agencies change every five years but utilities have to make decisions on investments and innovation that involve commitments over long periods of time. The ramifications of inadequate investment or stifling innovation will not emerge until long after the regulator has left office. This suggests that the framework of controls over regulators must be very robust.

In sum, the regulation now being applied fails the objectives of microeconomic reform and will stifle new technologies, denying the benefits of dynamic efficiency and improved quality of service to customers. In electricity, this will reduce the competitiveness of high

energy using industries over time, turning a natural comparative advantage for Australia on its head. What is needed is a much clearer direction and reform of the regulatory governance arrangements. Suggested changes to governance arrangements were provided in ENERGEX's original submission and are not repeated here.

2.3 Abuse of Market Power

The second point of clarification is that page100 of the Position Paper notes that ENERGEX's December 2000 submission favours 'at least half of the approach taken by the Hilmer Committee (1993, p279)'. The implication here is that ENERGEX favours an objects clause on economic efficiency but not on abuse of market power.

This is incorrect. The submission clearly states support for the abuse clause on page 2 in the Executive Summary and at page 18. Moreover, the submission also supports two additional clauses -–on promoting new entry and on fair benefit sharing – if command and control regulation is to continue.

What is particularly important about ENERGEX's clause on abuse is that it is worded to reflect the approach taken by the Federal Court and the ACCC to abuse; that is, "*giving less and charging more*". This is to avoid the interpretation given to abuse by regulators, who interpret it as a stock rather than a flow concept, and use it to argue that prices should equal the costs of the individual firms. Actually, regulators go further than this. This is evident in the choice of weighted average cost of capital (WACC) returns at the bottom end of the plausible range that independent experts could agree on. By definition, there can be no abuse if a rate of return is plausible so only the top end of the range should be selected. That is, even within the context of command and control regulation, regulators (Agents) are adopting their own objectives and not those of Principals (government and the community generally). They are using the WACC as a profit control mechanism, a purpose for which reform policy was never intended.

The objects clause proposed in the Position Paper does not include an 'abuse of market power' element. ENERGEX is unclear why this is so, unless the Paper is assuming that other parts of the TPA are sufficient, or the matter should be covered in industry-specific regimes, that making 'non-abuse' an objective could compromise the efficiency objective if it was interpreted too rigidly, or that the Commission intends to cover the matter in formal monitoring arrangements.

2.4 Recommended Objects Clause

The argument is made in the Position Paper that the productive (technical) and dynamic efficiency elements of economic efficiency are more important than allocative efficiency in infrastructure facilities. ENERGEX is fully supportive of this position.

On reflection, the abuse clause suggested by ENERGEX in its original submission is superfluous to a degree and would add complexity to an objects clause.

To precisely reflect principle and policy, ENERGEX suggests that the first part of the objects clause becomes:

To promote long term productive and dynamic efficiency, focusing on the desirability of fostering investment, innovation, productivity improvement, technical progress and diversity of choice, and taking precedence over allocative efficiency.

ENERGEX previously recommended that all forms of command and control regulation be mandated for elimination.

The Position Paper did not go that far but proposed requiring regulators to, in effect, show good cause why alternative approaches should not be implemented. ENERGEX considers that this proposal would be ineffective. Our concern is that no matter how precisely worded an objects clause may be, regulators will simply avoid the meaning of the words and the original intent and impose their own objectives. For instance, the Victorian legislative framework, including letters to the Victorian regulator from the Government, emphasised the need for light handed incentive regulation to improve dynamic efficiency. What regulated companies got was some of the most heavy handed command and control regulation there is outside of water regulation in the United Kingdom where, by definition under the perfectly competitive model, there would be no dynamism.

Several regulators have recently re-affirmed their commitment to building blocks although it is fair to say that others have indicated that they are prepared to change. ENERGEX re-affirms its commitment to its original recommendation which is now constructed as follows:

All forms of command and control regulation (cost of service/rate of return), including 'building blocks' and the use of a price cap where the 'X' is a residual, be mandated for elimination as regulatory options unless the regulated companies and their customers prefer such regulation and it can be shown that their proposal lies within the objects clause.

If such a preference is expressed, a further requirement should be added for the regulator:

To facilitate entry into relevant markets by setting prices based on the efficient cost and risk structures applicable to new entrants.

3. PRICING PRINCIPLES, FORMS OF REGULATION

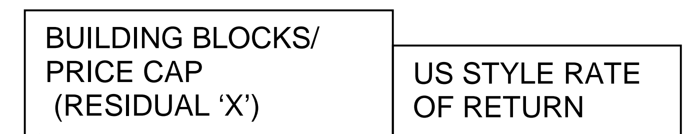
Chart 1 depicts a range of selected forms of regulation. The chart is only to illustrate an argument. There are other forms of regulation not covered (eg yardstick, franchise bidding, sliding scales) and the relative ranking of those selected is not precise, but this is not important to the argument.

The chart shows a disconnection between command and control and 'true' incentive regulation. It is sometimes claimed there is a continuum between these two approaches but this is incorrect, for the reason put in ENERGEX's December submission. All command and control forms are essentially bottom-up from cost whereas 'true' incentive regulation is top-down or price-based. That is, prices are de-linked from the costs of individual regulated firms.

Chart 1: Selected Forms of Regulation

HEAVY HANDED

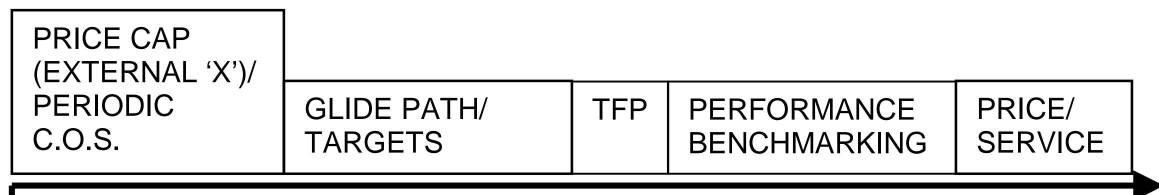
COMMAND & CONTROL
Cost of service/rate of return



- Profit control
- Methodological change, WACC squeeze
- Micromanagement
- Focus on forensic scrutiny of individual costs
- Second guess investment
- No innovation, service development
- No diversity of choice
- Higher prices overtime
- No abuse

LIGHT HANDED

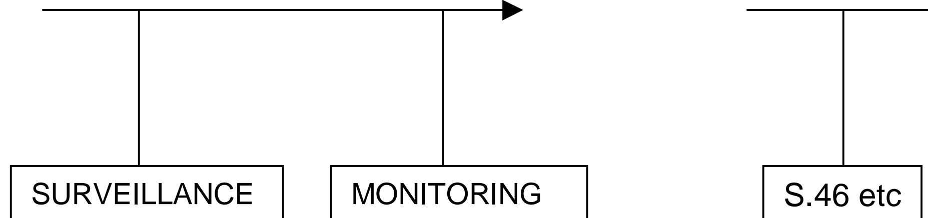
"TRUE" INCENTIVE REGULATION



- Profits uncontrolled
- Best practice benchmarks
- Investment, innovation
- Focus on customers
- Diversity of new services
- No abuse

PRICES OVERSIGHT

MINISTERIAL DIRECTIONS (VARIOUS)



The first box on the incentive side refers to "Price Cap (external X)/periodic cost of service". In this case, the X in the price based CPI-X mechanism reflects expected productivity. It needs to be made clear that this is fundamentally different to the "Building Blocks/Price Cap (Residual X)" on the other side. This is not an arcane distinction but goes to the heart of the debate on regulatory forms. The distinction has been the subject of an appeal in Victoria in October 2000 and of a recent Supreme Court action, both involving experts from around the world.

ENERGEX has previously outlined the relative merits of the various forms of regulation, with the exception of price-service offerings. ENERGEX is a member of the Regulated Businesses Forum which covers all regulated industries in Australia. It would be fair to say that there has been considerable debate about which form of light handed regulation should prevail, with differences between regulated industries and between firms in each industry. There is no clear preference.

In its Position Paper, the Commission appears to be favouring the first box on the incentive side. We are not certain from the Paper whether this involves periodic cost of service analysis of an individual firm or the construction of industry benchmark costs.

The view ENERGEX wishes to put to the Commission is that there seems no compelling reason for government or regulators selecting any particular form, as long as the proposal from the regulated business fits the objects clause. We would go further. Regulators have interposed themselves between regulated businesses and their customers. It is they who decide consumer preferences, not the customers and user industries. In our view, regulated businesses should seek out what customers want and offer a choice of regulatory form. Once those preferences are independently confirmed the role of the regulator would be reduced to ensuring that the criteria of the objects clause are satisfied.

ENERGEX would prefer a regulatory architecture which allowed various forms to flourish. We strongly oppose "consistency" or "uniformity" in approach, particularly when this involves command and control regulation. The Productivity Commission (Banks 1999) has previously suggested that there should be rivalry between jurisdictional regulators, so that good regulation would eventually drive out the bad. What ENERGEX is suggesting is similar:

Let any regulated business choose the form that best suits its interests and those of its customers as long as the objects clause is satisfied.

Some may prefer the quiet life of simple price caps, certain returns and minimal services. Others may wish to develop partnership with their customers and create high standards of quality and wide ranges of choice of services. That is what emulating effective competition in real world markets is all about.

4. PRICE-SERVICE OFFERINGS

During the 2001-2005 Electricity Distribution Price Review in Victoria, United Energy Limited (UEL) made a submission to the Office of the Regulator-General (ORG) described by a major social welfare group as *"as a decade ahead of anything else in the world".* However, even though it was 'strongly supported' by the great majority of UEL's customers (according to an independent survey), it was dismissed by the ORG. The reasons for the dismissal are unclear. The submission was made in response to the ORG's stated intention that its decision would be strongly influenced by what consumers preferred. When

asked by customers at a public forum why the submission was dismissed, the ORG made a response which, on further questioning, it subsequently retracted. Commentators have noted that the submission did not fit the command and control 'box' and would have meant that profits would no longer be fixed.

In its submission, UEL presented three alternative options to the ORG, two of which had been designed in consultation with customer and community groups, user industries, local councils and the like, as well as UEL's own Customer Consultative Committee. The 'Regulatory Base' option mirrored the command and control approach favoured by the ORG. The other two: the 'Customer Value' and 'Customer Premium' options proposed enhanced service offerings designed in the consultations and tied to incentive based regulation.

These three options became known colloquially in terms of types of motor vehicles: the Lada, Holden Commodore and the Mercedes-Benz respectively.

The Customer Value and Premium options depended on a Regulatory Contract which guaranteed to deliver a wide range of improved services, with the opportunity for UEL to gain a financial benefit or suffer a financial penalty based on its ability to perform. The range and degree of improved services went beyond anything yet seen in Australia. For example, the options proposed improvements in supply reliability to world's best practice as assessed by Pacific Economics Group. This was expected to increase the competitiveness of user industries and to lay the foundation for the needs of new technology industries. For instance, the target for minutes off supply per customer a year would be 52 minutes under the Customer Premium option, down from the standard of around 500 under public ownership and from around 200 in recent times under private ownership.

Another key element was the undergrounding of key areas of the network, improving the visual landscape, increasing safety and property values and having many other beneficial effects. This was the most strongly supported element, with over 80% of customers 'strongly' supporting the initiative. Other key areas of benefit to customers included:

- enhanced environmental benefits through a range of programs;
- enhancement of guaranteed service levels to world's best practice;
- initiatives with local government to support regional economic development, safety and security programs;
- a complex hardship policy designed to 'fix' the many problems and issues raised by community welfare groups in an efficient and equitable way; and
- innovative tariff structures.

The UEL approach was designed to emulate what happens in real world imperfectly competitive markets, where companies are induced and driven to achieve continuous improvement to satisfy customer preferences at best in class standards. According to UEL, it was also designed to build a major customer focussed cultural change within the organisation (p7, UEL Submission). The penalty for any failure to perform in the options was high - $10m and $20m respectively for the Customer Value and Premium options. On price, the Customer Value Option came at a marginally higher price that the Regulatory Base option but with no price increases. Of course, the level of services was vastly improved, and an increase in the quality of service is equivalent to a reduction price. Lower prices were expected over time, including from better management of the system and optimal use of the network. The Customer Premium required a small increase in price, but also committed to a much higher rate of investment in undergrounding and other benefits.

As remarked earlier, the great majority of UEL's customers strongly favoured either the Value or Premium options, with only a small part preferring the Regulatory Base.

ENERGEX also wishes to develop a competitive, innovative and customer focussed approach to regulation. This may not suit other regulated firms in energy or elsewhere or their customers. However, there is no obvious reason why regulators should forbid such developments which are clearly achieving the objectives of the Hilmer reforms and of CoAG. That said, UEL's pioneering approach is attracting more attention. For instance, the ESAA reported on 28 May 2001 that Energy Australia conducted a $1 million survey of customers which showed that they are prepared to pay significantly more for greater system reliability. Energy Australia is quoted as saying that the present regulatory approach militates against such improvements.

Of course there will be 'excess' to normal profits earned under UEL's approach by regulated companies that perform well against the standards in the Regulatory Contract. These are not monopoly rents in the usual sense but merely the necessary reward for achievement. Moreover, they will be 'blown away' as the standards become more rigorous over time, reaching and extending the production possibility frontier of best practice. On the other hand, those that fail to perform against the standards will pay a penalty, as occurs in any market.

Customers will be involved in the initial construction of the options and the sorts of services required. They will also have a 'vote' in deciding which option is to be preferred on presentation of the price-service offerings to the regulator. That is, they will have a choice about price-quality trade offs in the same way as buyers of cars. Moreover, customers will act as an important source of information to regulators in the monitoring of performance against the Regulatory Contract.

5. PRICES OVERSIGHT, TRADE PRACTICES LAW

In ENERGEX's December 2000 submission, it was concluded that, for the energy sector at least:

The Prices Surveillance Act 1983 be retained as a regulatory option.

There is no significant reason why an access regime is necessary beyond reliance on S.46 of the Trade Practices Act 1974 where ring fencing applies.

It is understood that the Productivity Commission is current contemplating these matters in ways beyond its stated position in the Position Paper. ENERGEX is unaware of what those advances are but would like to point out several matters that may have not been considered.

5.1 Governance

First is the question of what the appropriate governance arrangements for dealing with the regulation of natural monopolies under the Prices Surveillance Act should be. Key characteristics of the successful operations of the Prices Surveillance Authority were the public nature of its inquiries and the tripartite arrangements for Authority Members. Participant companies in those inquiries could be confident that all matters would be dealt with openly and be considered in an equitable way by Members drawn from what was, in effect, opposing interests. During the period of the Authority's existence, we are unaware of any breach of a PSA's determination even though penalties were negligible. We understand that this is not the case in the relatively short time the ACCC has been responsible for the PS Act.

The ACCC has a different construction and is, ultimately, a protector of consumer interests. It may not have the same credibility with regulated industry participants as under the PSA. ENERGEX also notes that, for a number of reasons, the Business Council of Australia is also suggesting that a national economic regulator should not be the ACCC. ENERGEX would like to point out that:

The tripartite arrangements for governance under the PC Act under the Prices Surveillance Authority may be superior to those that exist for the ACCC.

5.2 Monitoring

Monitoring has been a tool of prices oversight since the inception of the PSA in 1984. It was also a substantial activity of a predecessor body, the Prices Justification Tribunal in the period from 1978. The motivations for monitoring have varied. Initially, it was perceived as a means of maintaining low level scrutiny over areas where there was concern over prices but where declaration under S.21 of the Prices Surveillance Act was considered unwarranted.

Later on, monitoring of selected industries was carried out as a result of the findings of public inquiries, as part of tariff reform, and as part of microeconomic reform, including industry deregulation (eg the domestic air market). Deregulation of the former monopoly activities of Australia Post is one example of where monitoring played a role in scrutiny of both prices and service delivery performance. This is also occurring with airports.

In the 'New Directions in Pricing Policy" statement of November 1994, the Government gave further support to monitoring as a tool with greater flexibility to respond to pricing problems. The PS Act was subsequently amended to give the Minister the power to direct the ACCC to declare a firm for 'formal' monitoring under S.27A. Information collection powers are provided in S.32 (1)(e) and requirements regarding reporting and release of monitoring documents are in S.27B. Of course, the ACCC (and the PSA before it) conducts 'informal' monitoring for a variety of reasons.

The criteria in the Government's statement focussed on using formal monitoring when there are concerns about competition and pricing and where industries have been recently reformed or deregulated. It would appear that the essential questions to be addressed in formal monitoring reports are:

- whether there is on-going abuse of market power, and
- whether progress is being made towards a more competitive market where oversight is no longer required.

Section 27A of the Act gives powers to collect information on prices, costs and profits. Data or changes to the competitive environment in an industry are also usually collected. The intention appears to be that formal monitoring will focus on trends in movement in prices, costs and profits and not changes in prices of specific goods or services, which is the role of prices surveillance.

In ENERGEX's view, monitoring holds the potential for a less rigid and more cost effective tool of regulation, including when applied in light of the various provisions of the Trade Practices Act which deal with behaviour in markets. ENERGEX has already provided its views on the TPA in this respect, particularly S.46, in its December 2000 submission. Monitoring is more likely to be successful under the governance arrangements suggested above.

The purpose of monitoring regulated companies would be somewhat different to those originally intended for either formal or informal monitoring. These would presumably include ongoing compliance with the objects clause and the standards, Regulatory Contracts and so on which would be proposed under light handed regulation. ENERGEX suggests that the potential of monitoring as a regulatory tool is pursued:

The Productivity Commission should examine how the Prices Surveillance Act 1983 (the Act) contained in the Competition Policy Reform Act 1995 may be revamped to accommodate the specific requirements of the objects clause for regulated entities under formal monitoring, especially S.27A of the Act.

5.3 Surveillance

As is evident from the Second Reading Speech on the Prices Surveillance Bill by the Treasurer in 1983, the Government had reservations about surveillance and clearly intended that it be used sparingly, and not for control of prices or profits:

- *'…the scheme embodied in the Bill is one of price surveillance. Not price control.'*
- *'The PSA will not attempt to hold down prices by administrative fiat.'*
- *'Sound profits are an essential requirement for increased employment in the private sector.' 'An increase in profitability …..Prices surveillance will not be used to impede such a development.'*

In the Government's New Directions in Pricing Policy Statement, 1994, it is clear that:

- the new direction was to shift from surveillance to monitoring, with stricter criteria, or interpretation of criteria, for declaration but greater flexibility for enhancing productivity and profits by re-vamping the Ministerial Directions.
- greater emphasis was to be placed on having regulation foster investment, innovation and productivity.
- the cost-based surveillance system was regarded as rigid, backward-looking, interventionist and costly.

For example, the statement speaks of:

- *'Unwarranted surveillance adds to business costs affects investment planning and may jeopardise employment growth'* and
- *'we need a system (monitoring) which achieves price restraint in markets where competition is weak or non-existent without restraining business innovation, investment and efficiency'.*

The Productivity Commission itself (in a former guise) has expressed concerns in '*What future for prices surveillance?*', October, 1994, about surveillance and considered it should be limited to quite restrictive market conditions.

In ENERGEX's view, surveillance has a role in the regulation of infrastructure providers when used as a 'threat' for poor performance under a monitoring regime, as in New Zealand. This 'threat' would be made real if a firm:

- develops a mode of behaviour for failing to achieve the requirements of formal monitoring, or where
- there is strong reason to believe that a firm will use its market power to inflate profits or skimp on quality.

ENERGEX is unaware of the Commission's intentions for re-vamping the PS Act but offers the following comments. First, we would draw the attention of the Commission to a particular problem area arising from S.20 on Ministerial Directions (there is a subtlety here about directions which are statutory or otherwise). S17(3) of the Act provides directions which are really statutory guidelines to which the regulator must have particular regard. These cover the need to maintain investment and employment, including the influence of profitability on investment, the abuse of market power and a reference to wage fixation principles. These reflect the role of the PSA in the Accord which no longer exists and are not suitable for our purposes here.

Secondly, there are other Ministerial Directions. These have been changed quite frequently and currently number about five. One is the Unit Cost Direction issued by the Treasurer on 15 October 1985 and another is on executive remuneration. Again, these seem unsuitable for regulating infrastructure providers.

ENERGEX suggests:

Prices surveillance may have a role as a threat to companies which perform poorly under formal monitoring. If imposed, the Directions to apply should reflect the objects clause and the original intentions of the surveillance mechanism. In the latter case, this includes price restraint but not price or profit control, and ensuring sufficient profits for investment, innovation, efficiency and employment.

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